

# Tax memo

Canadian tax updates



## 2013 Federal budget: Alert for mining companies

*Outlines unexpected proposals in the 2013 federal budget that affect Canada's mining industry.*

April 10, 2013

This *Tax memo* discusses the measures in the March 21, 2013, federal budget that affect the Canadian mining industry. In particular, it focuses on the changes to:

- the tax treatment of pre-production mine development expenses; and
- the phase-out of accelerated tax depreciation for mining assets.

### ***Pre-production mine development expenses*** ***Current rules***

Currently, a taxable Canadian corporation that incurs development-type expenses (such as those incurred in removing overburden, stripping and sinking a mine shaft) for the purpose of bringing a new mine in a mineral resource in Canada into production in reasonable commercial quantities can treat them as Canadian exploration expenses (CEE).<sup>1</sup> Subject to certain restrictions, 100% of the balance in a taxpayer's cumulative CEE account can be deducted by the taxpayer in a taxation year, or carried forward indefinitely to future taxation years.

### ***Proposed rules: Phase-out of CEE treatment***

The 2013 federal budget proposes to phase out the CEE treatment for pre-production mine development expenses. Instead, these expenses will be treated as Canadian development expenses (CDE), which are deductible on a 30% declining balance basis.

Under the new approach, expenses incurred after March 20, 2013, will be treated proportionally as CEE and CDE, based on the following schedule:

	2013 and 2014	2015	2016	2017	After 2017
CEE	100%	80%	60%	30%	0%
CDE	0%	20%	40%	70%	100%

1. Pre-production mine development expenses are described in paragraph (g) of the definition of CEE in subsection 66.1(6) of the *Income Tax Act* (the Act).

### **Exception to phase-out of CEE treatment for 2013 to 2016**

Pre-production mine development expenses can continue to be treated as CEE before 2017 if incurred:

- a) under a written agreement entered into by the taxpayer before March 21, 2013;
- b) as part of the development of a new mine, if the construction of the mine was started by (or on behalf of) the corporation before March 21, 2013; or
- c) as part of the development of a new mine, if the engineering and design work for the construction of the mine, as evidenced in writing, was started by (or on behalf of) the corporation before March 21, 2013.

Consistent with the phase-out of investment tax credits in the 2012 federal budget, the terms “construction” and “engineering and design work” have not been defined for the purposes of determining whether (b) or (c) described above apply. However, neither term encompasses obtaining permits or regulatory approvals, conducting environmental assessments, community consultations or impact benefit studies and similar activities.

## **Accelerated depreciation for mining assets**

### **Current rules**

A taxable Canadian corporation that acquires certain depreciable property currently may be entitled to claim accelerated capital cost allowance (CCA) in a taxation year. The property must be acquired:

- for the purpose of gaining or producing income from a mine and was acquired before the mine came into production;<sup>2</sup>
- for a mine that was the subject of a major expansion where there was an increase of at least 25% in the designed capacity of the mine, subject to certain rules;<sup>3</sup> or

- for the purpose of gaining or producing income from a mine in a taxation year in excess of 5% of the taxpayer’s gross revenue from the mine.<sup>4</sup>

The regular CCA deduction available in respect of these assets is 25% of the undepreciated capital cost of the assets of that class, calculated on a declining balance basis. In addition, the corporation can deduct in a year up to 100% of the undepreciated capital cost of the eligible assets, but not exceeding the income from the new mine (after deduction of the regular CCA claim, but before any deduction for exploration and development expenses and interest expense).

### **Proposed rules: Phase-out of accelerated depreciation**

The 2013 federal budget proposes to phase out the accelerated depreciation allowance available for the mining assets described above. Corporations will be allowed to claim a percentage of the accelerated depreciation allowance based on the following phase-out schedule:

	2013 to 2016	2017	2018	2019	2020	After 2020
<b>Available allowance</b>	100%	90%	80%	60%	30%	0%

### **Exception to phase-out of accelerated depreciation for 2017**

The full accelerated depreciation allowance will be available if the assets are acquired before 2018 for a new mine or a mine expansion:

- a) under a written agreement entered into by the taxpayer before March 21, 2013;
- b) as part of the development of a new mine, if the construction of the mine was started by (or on behalf of) the corporation before March 21, 2013; or
- c) as part of the development of a new mine, if the engineering and design work for the construction of the mine, as evidenced in writing, was started by (or on behalf of) the corporation before March 21, 2013.

2. Class 41(a) of Schedule II of the Income Tax Regulations.

3. Class 41(a) of Schedule II of the Income Tax Regulations.

4. Class 41(a.1) of Schedule II of the Income Tax Regulations.

As with the proposed change to the treatment of pre-production mine development expenses, the terms “construction” and “engineering and design work” have not been defined for the purposes of determining whether (b) or (c) described above apply. However, neither term encompasses obtaining permits or regulatory approvals, conducting environmental assessments, community consultations or impact benefit studies and similar activities.

## ***PwC observations***

The changes proposed in the 2013 federal budget came as a surprise to many in the mining industry, especially following the phasing out of investment tax credits for pre-production mining expenditures that was proposed in the 2012 federal budget and subsequently enacted. In the supplemental information released with the budget, the Department of Finance indicated that it removed these incentives from the mining sector to “level the playing field” with the oil and gas sector, which does not enjoy those incentives, as well as to contribute indirectly to the government’s environmental goals.

## ***Grandfathering provisions***

An attempt has been made to grandfather mining projects that have reached certain stages of development on March 21, 2013, the date the changes were announced. However, companies may face some challenges in interpreting the proposed grandfathering rules. Our *Tax memo* “August 14, 2012 legislative proposals: Alert for mining companies” discusses these grandfathering rules in further detail ([www.pwc.com/ca/taxmemo](http://www.pwc.com/ca/taxmemo)).

## ***Mining: a capital intensive industry***

Mining is a capital intensive industry. Acknowledging this, the existing CEE and accelerated CCA rules were designed to allow mining companies to recover their capital investment before paying income taxes. The proposed changes will mean that the 100% deductions available for the cost of building a mine in Canada will now be amortizable on a declining

balance basis at the rate of 25% for depreciable property and 30% for the remaining costs of development. This will have some important effects.

## ***Move to declining balance depreciation***

The disadvantage of declining balance depreciation is that, although tax deductions are relatively high in the early years of use, the method usually results in the asset’s not being depreciated fully before the end of its useful life. That means, compared to the accelerated 100% claims previously available, a mining company will not be able to obtain a tax benefit for the entire cost of its investment, and the tax deductions will be spread thinly over the life of the mine. This will affect the internal rate of return of a planned project. This effect can be partially mitigated if a mining company:

- claims tax deductions before the mine comes into commercial production; and
- creates a non-capital loss carry forward balance.

## ***Rules no longer accommodate the mine lifecycle***

The accelerated CCA rules not only allowed a mining company to recover its initial capital investment before paying income taxes, accelerated CCA was also available for property acquired in the course of a major expansion of an existing mine. Often mining companies, when evaluating the economic feasibility of a project, use a two-phase approach to developing a project. Many mines are put into production using infrastructure designed for a high-grade deposit, knowing that further extensive capital investment will be made when the deposit’s grade reduces and the method of mining needs to be adapted.

The construction of the first phase of the project is often funded using funds obtained from the money markets, with the second phase funded from the profits from the project itself. A mining company previously was able to recover the cost of these expansions quickly through accelerated CCA, with this tax incentive often being an important component in the decision of whether the investment should be made.

In the budget documents, the government, in explaining its deletion of the accelerated CCA for the

cost of major expansions, indicated that “the tax treatment of intangible costs is only one of many factors that influence decisions to invest in mining projects. These changes will help ensure that investment decisions are based on market factors rather than income tax treatment.” In short, the government wants to remove tax savings from any investment decisions.

Removal of accelerated CCA for mine expansions may already have a chilling effect on expansions currently being evaluated for existing mines in Canada. This may mean that these investments simply will not be made, or that the monies that were being allocated to the expansions will be deployed into projects outside Canada. For junior mining companies evaluating a future project, the internal rate of return of a two-phase project likely will be reduced by the removal of the tax benefit of the second-phase expansion.

### ***Effect on the NI43-101 process***

National Instrument 43-101 (NI 43-101) is a standard for the public disclosure of information relating to mineral properties in Canada. The instrument is a codified set of rules and guidelines for reporting and displaying information related to mineral properties owned by, or explored by, companies that report these results on stock exchanges within Canada.

As part of the disclosure required by NI 43-101, a mining company prepares an economic analysis of the mineral property under consideration, which more often than not is an after-tax analysis (particularly for projects at the feasibility stage of development). Companies that have recently filed NI 43-101 reports will have to reevaluate, and in some cases redo the economic analysis using the revised CEE and CCA rules, to determine whether the new rules affect the internal rate of return of the subject project.

### ***Why is mining different from manufacturing?***

In the 2013 federal budget, the government chose to extend the incentives available to manufacturers for

two more years (the incentive applies to machinery and equipment acquired after March 18, 2007, and before 2014), in the form of a 50% straight-line CCA deduction for manufacturing and processing machinery and equipment. Even though mining often involves a significant amount of processing activity, mining companies have to settle for a CCA deduction equal to 25% of the capital cost of processing equipment acquired, calculated on a declining balance basis.

Given that the mining industry offers the same (and arguably more) benefits to the Canadian economy as the manufacturing sector through its investment in infrastructure, which often leads to jobs, a mining company should be entitled to at least the same CCA incentives offered to a manufacturing company. The government is clearly making a preferential choice, which detracts from its argument that investment decisions should be made based on market forces, rather than the tax treatment of costs.

### ***Effect on investment tax credits***

In drafting the proposals to treat pre-production mine development expenses as CDE, the Department of Finance amended the definition of CEE for expenses incurred during the transition period.<sup>5</sup> However, no corresponding changes to the investment tax credit (ITC) rules were proposed.<sup>6</sup> As a result, ITCs that should otherwise continue to be available for pre-production mine development expenses incurred before 2016<sup>7</sup> are no longer available after March 21, 2013.

The 2013 federal budget documents do not mention the removal of ITCs for pre-production mine development expenses. This omission likely was an oversight by the Department of Finance and might be fixed before the legislation is tabled in parliament.

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5. Pre-production mine development expenses incurred on or after March 21, 2013, but before 2018, are in new paragraph (g.3) of the definition of CEE in subsection 66.1(6) of the Act.
  6. The definition of “pre-production mining expenditure” in subsection 127(9) of the Act was not updated to include expenses included in new paragraph (g.3) of the definition of CEE.
  7. See our *Tax memo* “August 14, 2012 legislative proposals: Alert for mining companies” at [www.pwc.com/ca/taxmemo](http://www.pwc.com/ca/taxmemo).

## Other reasons for the changes

In its reasons for making the changes, the government indicated in the budget documents that “to the extent that these changes remove incentives that may contribute to a higher level of investment than would otherwise have occurred, they could contribute indirectly to goals in the Federal Sustainable Development Strategy relating to reducing emissions of greenhouse gases and minimizing threats to air quality, protecting water quality, and conserving ecosystems and habitat.” These are unusual comments for a government to make in respect of a struggling economy that will rely heavily on the resource sector to drive its GDP growth into the future.

## We can help

For more on the implications of the 2013 federal budget changes, please contact your PwC advisor or any of the individuals listed on this page.

## PwC contacts

<b>Toronto</b>	Liam Fitzgerald	416 869 2601
	<i>liam.m.fitzgerald@ca.pwc.com</i>	
	John Gravelle	416 869 8727
	<i>john.gravelle@ca.pwc.com</i>	
	Lana Paton	416 869 8700
	<i>lana.paton@ca.pwc.com</i>	
<b>Montreal</b>	Rene Albert	514 205 5077
	<i>rene.albert@ca.pwc.com</i>	
	Claire Van der Tol	514 205 5258
	<i>claire.van.der.tol@ca.pwc.com</i>	
<b>Vancouver</b>	Garry Eng	604 806 7037
	<i>garry.eng@ca.pwc.com</i>	
	Tim Johnston	604 806 7831
	<i>tim.w.johnston@ca.pwc.com</i>	
	Sean Wilson	604 806 7187
	<i>sean.wilson@ca.pwc.com</i>	

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